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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Consolidation in Banking

The banking industry continues to consolidate throughout the United States, but at a slower pace than in the past two decades and in particular since 2007. Consolidation occurs from a number of factors with banks experiencing loan and securities portfolio problems resulting in inadequate capital on one hand and the pricing of banks in acquisition transactions on the other hand. In some cases, the regulatory compliance cost for small community banks has caused them to seek merger partners. The Federal Deposit Insurance Corporation ("FDIC") reports that the number of insured institutions has declined over 41% since 1992. As of November 14, 2013, there were 6,878 of FDIC insured institutions.

In some cases, depressed stock prices for publically traded financial institutions has been factor in the decline in merger and acquisition activity because there is less buying power by an acquirer with the result that a healthy institution is unwilling to accept a lower price. Probably the most significant factor in the decline is the closure of banks by the FDIC resulting in acquirers for banks purchasing the assets of the closed bank at a modest premium of the deposits, and the FDIC entering into a loss-sharing agreement with the acquirer on potential loan and asset losses. Because of FDIC closure of banks and the utilization of loss-sharing agreements, acquirers have in some cases either excluded or escrowed problem assets in making an acquisition of a healthy bank thereby leaving the risk of collection of the problem assets with the shareholders of the acquired institution. This is sometimes referred to as the *good bank bad bank* with the shareholders of the selling bank retaining certain of the nonperforming assets.

The number of bank transactions has continued to decline since 2006 when the average reflected a price/book multiple of 2.36 and price/earnings ratio of 27.87. In 2007 the average reflected a price/book multiple of 2.20 and a price/earnings ratio of 22.65.

The year 2012 reflected a higher number of bank transactions of 236 compared to 178 transactions that were announced during 2011. The average price to tangible book was 114.86% during 2012 for the 139 transactions with disclosed terms compared to 106.42% during 2011 for the 101 transactions with disclosed terms and 115.38% during 2010 for the 121 transactions with disclosed terms. During the first eleven months of 2013, the pricing of banks has seen a positive increase. Although there are still acquirers for banks, they are much more selective in the acquisitions that are being made.

Recent surveys indicate that the minimum asset level a community bank must achieve to remain independent is at least $1 billion or more. Because of regulatory reform and compliance costs, many community banks will be active in seeking a merger partner. Surveys reflect regulatory compliance continues to be an impediment for growth within community banks.

Prior to 2007 there had not been a bank failure since the second quarter of 2004. During 2007 there were three bank failures with the largest being NetBank located in Georgia with approximately $2.5 billion in assets and $2.3 billion in total deposits. During 2008 there were twenty-five bank failures with the largest being Washington Mutual Bank located in Washington with approximately $307 billion in assets and $188 billion in deposits.

During 2009 there were one-hundred forty bank failures with the largest being Colonial Bank located in Alabama with approximately $25 billion in assets and $20 billion in deposits. During 2010, there were one-hundred fifty-seven bank failures with the largest being AmTrust Bank located in Ohio with approximately $12 billion in assets and $8 billion in deposits.

During 2011, there were ninety bank failures with the largest being Superior Bank located in Alabama with approximately $3 billion in assets and $2.7 billion in deposits. During 2012, there were 51 bank failures with the largest being Tennessee Commerce Bank located in Tennessee with approximately $1.19 billion in assets and $1.16 billion in deposits.

During the first eleven months of 2013, there were 23 bank failures with the largest being First National Bank located in Edinburg, Texas with approximately $3.1 billion in assets and $2.3 billion in deposits. During the first eleven months of 2013, it is noteworthy that of the 23 bank failures fourteen had assets of less than $135 million.

In its Third Quarter 2013 Banking Profile Report, the Federal Deposit Insurance Corporation reported negative news in aggregate net income by banks of $36 billion in the third quarter, a $1.5 billion decline from the previous year. This is the first time in seventeen quarters that earnings registered a year-over-year decline. The earnings decline was mainly attributable to a $4 billion in litigation expenses at one institution.

The number of institutions on the FDIC's problem list declined for a tenth consecutive quarter from 553 to 515 during the third quarter. During the recent financial crisis, the number of problem banks reached a high of 888 at the end of the first quarter of 2011. Problem banks are characterized as those institutions having a risk of failing and being closed by the FDIC.

The close of 2013 marked the third year in a row that there has only been one new bank charter. Except for the one recent bank charter approved by the FDIC, the last de novo charter occurred in the fourth quarter of 2010. Bank of Bird-in-Hand was recently approved by the FDIC and will primarily serve a small farming community located east of Lancaster, Pennsylvania. The bank was organized with $17 million of capital by Amish businessmen with the shareholders being evenly split between Amish and non-Amish investors.

As in the past, probably one of the biggest issues facing banks during the coming year will be the ability to raise capital, not only for acquisitions, but for credit quality issues relating to loan portfolios and securities portfolios.

Our firm is experienced and available to answer questions regarding the raising and placement of capital and matters relating to merger and acquisition transactions.

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